The Asian crisis and world capitalism

A warning from Dr Greenspan

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Testimony delivered last week to the US House of Representatives by Federal Reserve Board chief Alan Greenspan and Treasury Secretary Robert Rubin has highlighted growing fears in world financial circles that the Asian crisis, far from being over, is only just beginning.

The circumstances in which the testimony was delivered were themselves extraordinary. The two most powerful figures in the world of global finance were forced to go cap in hand to the House agriculture committee, asking Congress to approve the Clinton administration's request for an $18 billion increase in reserves for the International Monetary Fund.

In the past, such a request would have been a matter of routine. Such are the divisions in US ruling circles that today it is being bitterly opposed, amid calls for the IMF to be scrapped altogether.

In an effort to counter such tendencies, Greenspan and Rubin warned that if the crises which hit Thailand, Korea and Indonesia spread, the IMF would not have sufficient funds to stem a widening collapse. A global financial panic could result.

"These occurrences are possible, and the consequences to us could be severe," Rubin said. "We cannot afford to take the risk that such events could start to unfold and the IMF does not have the capacity to cope effectively."

He said the IMF had about $15 billion left after commitments already made -- not enough to deal with another Asian crisis.

Greenspan's testimony, like previous speeches he has delivered on the Asian crisis, demonstrates that the world's central bankers have no clear comprehension of the operations of global financial markets, and no plan for controlling their violent movements.

The global system, Greenspan told the congressional committee, exposed and punished "underlying economic imprudence swiftly and decisively" but regrettably "it also appears to have facilitated the transmission of financial disturbances more effectively than ever before."

"We do not as yet fully understand the new system's dynamics. We are learning fast, and need to update and modify our institutions and practices to reduce the risks inherent in the new regime. Meanwhile, we have to confront the current crisis with the institutions and techniques we have."

Answering critics of the IMF who have maintained that the crisis in East Asia should have been allowed to run its course without any outside intervention, Greenspan warned that such an approach was too risky.

"There was and is ... a small but not negligible probability that the upset in East Asia could have unexpectedly large negative effects on Japan, Latin America, and eastern and central Europe that, in turn, could have repercussions elsewhere, including the United States.

"Thus, while the probability of such an outcome may be small, its consequences, in my judgment, should not have been left solely to chance. We have observed that global financial markets, as currently organised, do not always achieve an appropriate equilibrium, or at least require time to stabilize. Moreover, the effects of the Asian crisis on the real economies of the immediately affected areas, as well as on our own economy, are only now just being felt."

The impact on the "real economies" is reflected in the latest growth estimates. The East Asian region, which has contributed half the growth in world output throughout this decade, is contracting.

In Indonesia estimates of an 8 percent growth rate for 1998, made a year ago, have now been revised downwards to negative growth of at least 9 percent, while other estimates put the contraction at between 10 and 15 percent.

The South Korean economy, now in the grip of a credit squeeze imposed by the IMF as part of its restructuring program, is expected to contract by at least 4 percent, while Thailand will experience negative growth of at least 7 percent.

But serious as the downturn is in the former "Asian tigers," it is overshadowed by the crisis in Japan. Last week the Bank of Japan admitted for the first time that the economy could be entering a deflationary spiral in which "production, income and expenditure show negative interactions with each other". In such a situation, falling production gives rise to declining incomes, leading to expenditure cutbacks and further falls in output.

According to the conventional economic wisdom, such a vicious economic circle is countered by increases in government spending and reductions in bank interest rates.

However both these supposed remedies have already been tried and failed in Japan. Despite a series of stimulation

packages, combined with cuts in interest rates to record lows, the Japanese economy is set to show negative growth in 1998.

The main reason for the failure of the stimulation packages is the weight of bank debt. Official Ministry of Finance figures put the bad debt of the banks at $600 billion, but according to other estimates it may be at least 40 percent higher. In other words, the negative economic impact of the banking crisis is equivalent to twice the Gross Domestic Product of Australia.

And the crisis in Asia is worsening the position of the Japanese banks, which are estimated to have around $44 billion in bad loans to the region. Loans outstanding in Indonesia alone total $23 billion -- none of which will be repaid unless the value of the rupiah is increased.

The banking crisis is also having a significant impact on capital markets and the value of the yen. With interest rates at an historic low, money is moving out of Japan to seek a higher rate of return in the United States.

This outflow of capital is in turn leading to a fall in the value of the currency. On May 19 the yen went to 137 to the dollar -- its lowest point in six years. Figures for April show that during that month the Bank of Japan spent $21 billion, nearly a tenth of its total reserves of $220 billion, attempting to boost its value.

The chief motivation for the bank's defence of the yen is the fear that a rapid devaluation -- to 150 or even lower -- will set off a new round of currency depreciations through the region.

An abrupt fall in the yen will place increased pressure on the South Korean won, leading in turn to a devaluation of the Chinese currency. This could trigger a "second wave" of currency collapses across the East Asian region, with far-reaching recessionary consequences for the world economy.

Already the effects of the Asian financial crisis are starting to show up in US economic statistics. The trade deficit in goods and services, resulting from cheaper imports and cuts in export markets, was $13 billion in March -- the highest monthly level in history. The trade gap for the first three months of the year was $36.8 billion, an increase of 26 percent on last year.

In his testimony to the agriculture committee Rubin noted that around 16 percent of all US farm production goes to Asia. Exports to key countries in the first three months of the year were down $23 billion on an annualized basis, he said, with the situation likely to worsen in the period ahead.

In the crucial electronics industry growth estimates are being revised down. Earlier this year the $136 billion semi-conductor industry was predicted to grow by 7 percent in 1998. Now the estimate is for a contraction of 0.6 percent.

Overall the contraction of economic demand from the East Asian region is calculated to be around one trillion dollars.

Within business circles earlier hopes that the major western nations had been able to ride out the Asian collapse are giving way to a much more pessimistic outlook and the expression of fears that the worst is yet to come.

An editorial in the London-based *Financial Times* of May 23 warned: "The longer the Asian crisis goes on, the greater the repercussions for the rest of the world could be. And at the moment, the end does not seem in sight. Worse, another twist of the vicious circle, with further damaging currency devaluations and resulting financial problems still cannot be ruled out."

Western countries had yet to receive the full force of the crisis, the editorial stated, and there were dangers of a second round of currency devaluations. If either, or both, the Japanese yen and the Chinese renminbi were to plunge, "the effect on the world economy would dwarf the impact of the Asian crisis so far," sparking a new round of devaluations and undermining Western stock markets.

Across the Atlantic, the June 1 *BusinessWeek* magazine featured a series of reports on the worsening Asian situation and published an editorial comment placing blame on the Japanese government, the US Treasury and the IMF.

"Asia is poised on the brink of depression," it declared. "A deadly deflationary spiral has started in Japan and China that must be reversed. Wild inflationary fires are burning in Indonesia. Throughout Asia, economies must be reliquified and companies must be recapitalized to jump-start economic growth. People in the US, Japan, or Europe who think they can dodge this bullet are dreaming. The global economy is at risk."

Underlying such strident warnings is the fear that unless the economic situation is brought under control -- and no one has a plan for doing so -- then the tumultuous events in Indonesia over the past weeks will be followed by no less profound social and political upheavals across Asia, and in the major capitalist countries as well.